Index Returns

<table>
<thead>
<tr>
<th>YTD</th>
<th>% Change</th>
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<tbody>
<tr>
<td>11/30</td>
<td>From 10/31</td>
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**Bonds**
- Short-term: +5.4% +0.3%
- Intermediate: +8.1% +0.2%
- Long-term: +12.3% +1.0%
- Global: +7.6% +0.5%

**U.S. stocks**
- Large Market: +30.9% +4.6%
- Large Value: +26.4% +1.0%
- Small Market: +24.2% -1.5%
- Small Value: +30.6% -0.9%
- Real estate: +16.7% +1.8%

**Int’l stocks**
- Large Market: +4.3% -0.1%
- Large Value: -2.8% -4.3%
- Small Market: -18.7% -8.1%
- Small Value: -18.3% -8.4%
- Emerging Mkt.s: -18.4% -5.3%

Short-term bonds = DFA One-Year Fixed Income fund; Intermediate bonds = DFA Intermediate Government Bond fund; Long-term bonds = Vanguard Bond Index Long-term; Global bonds = DFA Global Fixed Income fund; U.S. Large Market = Vanguard Index 500 fund; U.S. Large Value = DFA Large Cap Value fund; U.S. Small Market = DFA 6-10 Small Company fund; U.S. Small Value = DFA Small Cap Value fund; Real Estate = DFA Real Estate Securities fund; Int’l Large Market = DFA International Large Cap fund; Int’l Large Value = DFA International Large Cap Value fund; Int’l Small Market = DFA International Small Company fund; Int’l Small Value = DFA International Small Cap Value fund; and Emerging Markets = DFA Emerging Markets fund.

This information is obtained from sources we believe are reliable, but we cannot guarantee its accuracy. Past performance does not guarantee future returns.

Markets Update

Wednesday, December 10, 1997

The U.S. markets have recovered almost all of their declines of October with large blue-chip stocks leading the way. The S&P 500 Index has gained 34.6% through 12/8. U.S. small company stocks are also doing very well with the DFA 6-10 Value fund up 32.6% year-to-date. In contrast, the average small company fund according to Lipper Analytical has only managed a 17.4% return for the year.

The foreign markets continue to struggle, with the problems of Southeast Asia creating uneasiness in most world markets and forcing fundamental economic changes in some. We discuss these changes and their potential implications in the following article.

**A Movement Toward U.S.-Style Markets**

*Why we should be optimistic about Asia’s long-term future*

Diversification among the developed foreign markets is an important ingredient of all TAM portfolios. Over time, portfolio volatility should be reduced and returns enhanced by adding equity investments in countries like Japan, Germany, and the United Kingdom. Occasionally, we experience periods when these markets are less than stellar performers, but looking long-term it’s hard to make a case against international diversification.

We also include shares of companies in eleven “emerging markets” using the DFA Emerging Markets Index fund because we expect the economies of these countries to grow at higher rates relative to our own, again, over the long-term. When situations develop like the current “Asian Crisis” it’s easy to see how investors—even those with long-term time horizons—might lose faith in the merit of these investments.

This article discusses some fundamental economic changes that appear to be transpiring in many of the Asian markets and why these changes should be a source of optimism for global investors.

At the core of the indexing argument is the belief that free markets, unencumbered by government interference and centralized planning, will result in the most efficient and profitable distribution of capital. This, in turn, will result in fair prices for corporate securities on an ongoing basis.

In other words, a very broad base of stock and bond investors buying and selling over well-run securities exchanges will allocate capital to enterprises more efficiently than committees of politicians, bankers, or other “experts” who generally claim intellectual superiority over “the masses.”

We see the evidence of this in many areas: the collapse of communism and centrally-planned economies; the restructuring of American corporations and the current bull market; the growing popularity of indexing as a long-term...
investment strategy, and, more recently, the decline of the Japanese and Asian economies.

It was not long ago that experts were lashing out against U.S. corporate managers and their focus on short-term profits while praising the Japanese for their system of encouraging businesses to take a long-term view. Japan, it was thought, was doing the right thing by encouraging cross-holding of shares among corporations and emphasizing bank financing over bond financing. The result was that corporate stockholders and the lending banks were much more forgiving of management mistakes and too often accepted the excuse that “things will work out over the long-run.” Banks held on to bad loans and corporations held on to overpriced stocks too long as a result.

In contrast, millions of individual investors, mutual fund managers, and retirement plan sponsors, voting daily through their buying and selling on organized securities exchanges, would never have been as forgiving or patient.

It has taken most of this decade, but it appears that Japan’s government and its corporate leaders have come to realize the value in the U.S. model and are now moving more quickly to embrace it. In the emerging markets change might come even sooner: the IMF agreement to bail out South Korea included structural changes that replaces their Japanese-style financial system with the U.S. model of capitalism.

As the table shows, investors in this country provide more of the debt capital to corporate America than do banks. If the market (all of us collectively) is more efficient in judging and pricing corporate risk than bankers and politicians, which financial system is more likely to be embraced over time?

It’s a credit to the believers in free markets in this country and the leadership of politicians like former president Reagan that the U.S. did not go the way of Japan. Lester Thurow, the dean of MIT’s Sloan School of Management and Jeffrey Garten, dean of the Yale School of Management wrote books as recently as 1992 praising “Japan, Inc.” Harvard Business School professor Michael Porter headed a national commission calling for major changes in the U.S. system.

According to them, the focus on short-term profits in the U.S. was supposed to undermine our long-term competitiveness in the world markets. What it’s done instead is to force corporate managers to become more competitive and allocate resources to those products and services most in demand and to generate high returns to their shareholders. Investors, in turn, have been more willing to supply capital to those companies they perceive to be managing their businesses to maximize profits. Investor do this through the purchase (or sale) of stocks and bonds.

A major concern with the focus on short-term profitability is the potential for underfunding research and development. A free and efficient securities market, however, forces corporate managers to work harder to balance the desire of investors for consistent growth in earnings and shareholder value with the need to develop new products and services. Managers who fail to achieve this balance will find their stocks priced lower to reflect the higher risk and uncertainty of their operations. It’s usually only after the market has spoken that a company’s directors (or, increasingly, mutual fund managers and other shareholder activists) pressure current management for positive changes, or they bring in fresh blood to turn the company around.

In hindsight it’s easy to look back and see the flaws in a system like Japan’s and how they could carry over to the developing markets in the region. So why didn’t the “experts” see it coming? Some did, of course, but they were then faced with determining the degree of a correction and its timing. Many of these experts also missed out on the phenomenal growth in Japanese markets prior to the period of decline. I would also venture to say that these same experts have been participating in the Asian emerging market growth despite the underlying structural similarities to Japan.

Investors following a value-indexed strategy profit from the U.S. model of capitalism by ignoring the short-term gyrations of individual stocks and simply participating in the benefits derived from a diversified portfolio over time. Companies that fail to achieve a balance between current earnings growth and the development of attractive future products and services become the value opportunities we will gladly exploit.

The fact that much of the rest of the world is moving toward the free-market model of the U.S. should further strengthen the argument for global diversification.

—Jeff Troutner

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<tr>
<th>% of Gross Domestic Product</th>
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<tr>
<td>Bank Loans</td>
</tr>
<tr>
<td>U.S.</td>
</tr>
<tr>
<td>Japan</td>
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<td>Germany</td>
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